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BEFORE THE OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

IN THE MATTER OF THE APPEAL OF, )  
 )  
FMI CORPORATION, ) OTA NO. 220510490  
 )  
 ) APPELLANT. )  
 )  
 )  
\_\_\_\_\_ )

Transcript of Electronic Proceedings,  
taken in the State of California, commencing  
at 11:16 a.m. and concluding at 11:36 a.m. on  
Wednesday, July 19, 2023, reported by Ernalyn M.  
Alonzo, Hearing Reporter, in and for the State  
of California.

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APPEARANCES:

Panel Lead: ALJ SARA HOSEY

Panel Members: ALJ KENNY GAST  
ALJ LAUREN KATAGIHARA

For the Appellant: RICK NAJJAR

For the Respondent: STATE OF CALIFORNIA  
FRANCHISE TAX BOARD  
CHRISTOPHER COOK  
ERIC YADAO

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I N D E X

E X H I B I T S

(Appellant's Exhibits 1-5 were received at page 7.)

(Department's Exhibits A-M were received at page 7.)

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California; Wednesday, July 19, 2023

11:16 a.m.

JUDGE HOSEY: We are now on the record.

This is the Appeal of FMI Corporation, OTA Case Number 220510490. Today it's 11:16 a.m. on July 19th, 2023. This appeal is being conducted electronically lead by myself Judge Hosey via Webex.

With me today are Judge Lauren Katagihara and Judge Kenneth Gast. I'm the lead judge for the purpose of conducting this hearing today, but all three judges on the panel are co-equal decision makers.

I want to remind today's participants and viewers that the Office of Tax Appeals is not a court, but an independent appeals body. The office is staffed by tax experts and is independent of the State's tax agencies. OTA does not engage in any ex parte communications with either party.

Our decision will be based on the arguments and evidence provided by the parties on appeal in conjunction with an appropriate application of the law. The Panel has read the briefs and examined the submitted exhibits, and we're looking forward to your arguments today.

Can I have the parties' representatives introduce themselves please, starting with the Appellant.

1 MR. NAJJAR: Rick Najjar for this LLP.

2 JUDGE HOSEY: Thank you.

3 And Respondent.

4 MR. COOK: This is Chris Cook Tax Counsel with  
5 the Franchise Tax Board.

6 MR. MURADYAN: This is David Muradyan with the  
7 Franchise Tax Board as well.

8 JUDGE HOSEY: Thank you. The issue identified on  
9 appeal is whether Appellant has established reasonable  
10 cause to abate the delinquent penalties and late-filing  
11 penalties imposed on tax years 2014 through 2018.

12 Does this properly reflect your understanding of  
13 the issue, Mr. Najjar?

14 MR. NAJJAR: That properly reflects my  
15 understanding, Your Honor.

16 JUDGE HOSEY: Thank you.

17 And Mr. Cook?

18 MR. COOK: Yes, Judge Hosey. That's the issue.

19 JUDGE HOSEY: Great. Thank you.

20 As for our exhibits today, Appellant submitted  
21 Exhibits 1 through 5, and Respondent submitted Exhibits A  
22 through M. No objections were made to the exhibits.  
23 Therefore, Exhibits 1 through 5 and A through M are hereby  
24 admitted as evidence into the Record.

25 ///

1 (Appellant's Exhibits 1-5 were received  
2 in evidence by the Administrative Law Judge.)  
3 (Department's Exhibits A-M were received in  
4 evidence by the Administrative Law Judge.)  
5 JUDGE HOSEY: Let's move forward with the  
6 parties' presentations. We'll begin with Mr. Najjar.  
7 You have 15 minutes when ready.

8  
9 PRESENTATION

10 MR. NAJJAR: Sure. And thank you for the OTA for  
11 hearing our case today.

12 So I'll just start with a factual overview of  
13 what happened. FMI Corporation is an S corporation  
14 legally incorporated in North Carolina. It provides  
15 investment banking type services and consulting services  
16 primarily to the construction industry. Throughout my  
17 presentation I'll just refer to FMI as Appellant.

18 So Appellant in 2005 contemplated in actually  
19 opening up a physical office and making an investment in  
20 the State of California. So naturally in anticipation of  
21 getting ready to open up this office, they registered to  
22 do business with the Secretary of State. They didn't  
23 register with any other California agency and definitely  
24 not the taxing agency.

25 There was no other visits to California. No

1 other investment in California. Nothing to do with the  
2 physical location. The plans to open the physical office  
3 were totally abandoned. However, the registration with  
4 the Secretary of State was still out there. Despite  
5 Appellant's best efforts, it didn't successfully withdraw  
6 the registration. So that has stayed on the Secretary of  
7 State's records.

8 The next thing I want to point out is from 2005  
9 to 2020 Appellant did not file an income or franchise tax  
10 return with the California FTB. And to also note they  
11 were not physically present in California, but from 2011  
12 on they exceeded the factor presence threshold that was  
13 enacted in 2011 under Section 23101. Given the  
14 constitutional law at the time and the precedent set by  
15 Quill v North Dakota, the Appellant believed that a  
16 physical presence was still necessary for California to  
17 impose any other tax law, not just sales and use tax, but  
18 any tax. And I'll get back to that in a little bit.

19 However, as we all know after Wayfair v South  
20 Dakota was decided in June 2018, shortly thereafter the  
21 Appellant decided to reevaluate their potential tax  
22 exposure across several states, including California.  
23 Because California had passed the factor presence nexus  
24 test in 2011, under Section 23101 of the Revenue &  
25 Taxation Code, Appellant, after internal deliberations and

1 consultations with outside tax advisers, believed that it  
2 would be best to file past tax returns.

3 And, you know, essentially Appellant believed  
4 that the Wayfair case validated any constitutional  
5 concerns or ameliorate any constitutional concerns when it  
6 came to Section 23101. Appellant would have liked to  
7 enter into the FTB's voluntary disclosure program, but was  
8 not able to do so given the registration that was still on  
9 the Secretary of State's records. So if you're registered  
10 with the Secretary of State, the FTB does not allow you to  
11 enter into its voluntary disclosure program.

12 Nonetheless, Appellant filed the necessary  
13 returns for 2014 through 2018 on June 26, 2020, along with  
14 the proper payments. And you can see that in the FTB's  
15 Exhibits A through F. The FTB, after examining these  
16 returns, assessed the late-filing penalty and a delinquent  
17 penalty for each period. And you can see that with  
18 Exhibits H through L of the FTB's exhibits. And there was  
19 applicable interest. Appellant paid these amounts in full  
20 and then subsequently requested a refund on the basis that  
21 there was reasonable cause to waive these penalties to  
22 begin with. The FTB subsequently denied the refund based  
23 on finding that there was no reasonable cause.

24 So just to give an overview of our argument, when  
25 Appellant was looking at opening an office in 2005, they

1 were simply relying on state tax publications and what the  
2 state law was in California at that time, which to the  
3 best of the Appellant's understanding was that a physical  
4 presence was necessary to file an income tax return.  
5 After they would open up the office, they planned on  
6 filing an income tax return. But until that time, until  
7 physical presence was generated, it's their position and  
8 it was clear in California guidance that without a  
9 physical presence there would never be a filing  
10 requirement, even despite registering with an agency like  
11 the California Secretary of State.

12 Post 2011, we realized the FTB's -- Appellant  
13 realized the FTB's position is 23101 applies, and that  
14 physical presence is no longer required and we --  
15 Appellant also recognizes that in California FTB Technical  
16 Advice Memorandum Number 2012-01 published on  
17 November 29th, 2012. This guidance discusses that Quill  
18 is definitely not applicable to income and franchise  
19 taxes, and that the factor presence nexus threshold  
20 applies.

21 Nonetheless, the FTB and the legislature cannot  
22 decide a federal constitutional issue. So what this means  
23 for reasonable cause is that while ignorance of the law  
24 itself is not reasonable cause, a good-faith effort to  
25 comply with the law and understanding that novel issues

1 exist at the time can be considered reasonable cause. So  
2 this -- it's Appellant's position that this is a novel  
3 issue because even though California guidance came out and  
4 said we no longer follow Quill or require physical  
5 presence or believe physical presence is required for  
6 income tax filing, it was still up in the air from a  
7 constitutional perspective until Wayfair was decided in  
8 June of 2018.

9 When evaluating whether or not this is a novel  
10 position, it doesn't matter if the position is ultimately  
11 right or wrong, which I think we can all agree that it was  
12 probably not correct that a physical presence was required  
13 for income tax. But there's definitely -- there  
14 definitely was as a tremendous amount of debate before  
15 2018. You can look at any academic journal law reviews or  
16 business journals, et cetera, et cetera, and find that  
17 there was a tremendous difference of opinion.

18 Any major tax advisory firm would also say that  
19 there is a difference of opinion and there is risk, but  
20 it's definitely a reasonable position to take that a  
21 physical presence would be required prior to 2018.

22 Circling back to reasonable cause if it's a novel position  
23 that that's established, there are several cases in the  
24 federal realm which have done a very good job of refining  
25 what reasonable cause means. For instance, Williams v

1 Commissioner in 2004, and they stated where a case is one  
2 of first impression with no clear authority to guide the  
3 decision makers. That's the major and complex issue and  
4 the negligence penalty is inappropriate. I think that  
5 sums it up all here.

6 Again, I recognize -- the Appellant recognizes  
7 that California did publish guidance in 2012 saying this  
8 is what we're going to do now. But again, this is a  
9 constitutional issue, and it is still reasonable given  
10 that it's not a fringed theory that the taxpayer was  
11 subscribing to but one that's quite widespread. Moreover,  
12 we're not asking for forgiveness of the tax, just the  
13 penalties. In the sales and use tax realm, once many  
14 states put in their factor presence test or economic nexus  
15 threshold after Wayfair, they weren't going to collect  
16 back taxes, interest, and penalties from that rule, even  
17 though the Supreme Court came and said for sales tax Quill  
18 is wrong.

19 But in closing we just believe that this is a  
20 reasonable position to take for the tax years at issue.  
21 The taxpayer was aware that there could be filing  
22 obligations for those years at issue but just did not  
23 subscribe to -- did not acquiesce to states that were  
24 putting in factor presence nexus standards like California  
25 and a few others at that time.

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Thank you.

JUDGE HOSEY: Thank you, Mr. Najjar.

I'm going to go ahead and see if the Panel has any questions for you before we move forward with the Franchise Tax Board's presentation.

Judge Katagihara, any questions for Appellant?

JUDGE KATAGIHARA: No questions for Appellant.

Thank you.

JUDGE HOSEY: Thank you.

Judge Gast, any questions for Appellant?

JUDGE GAST: This is Judge Gast. I have one question for Appellant. You said that the company was registered with the California Secretary of State in 2005 and forward. And if so, how does that fit into your reasonable cause argument?

MR. NAJJAR: Sorry, Judge Gast. The taxpayer did register with the Secretary of State in 2005. But after it abandoned plans to open the office, did its best to withdraw from the Secretary of State given it would have nothing to do -- or what it believed nothing to do with California at the time.

With that also in mind, especially at that time, they still believed, like, if there's no physical presence, there's not going to be a tax filing obligation. So despite registrations under the Quill standard, that's

1 still -- that still was not enough to generate a filing  
2 requirement for taxes.

3 JUDGE GAST: Okay. Thank you. That's all the  
4 questions I have.

5 JUDGE HOSEY: This is Judge Hosey. Thank you,  
6 Mr. Najjar.

7 We'll go ahead and move to Respondent's arguments  
8 presentation.

9 Mr. Cook, are you ready to begin?

10 MR. COOK: Yes, Judge Hosey. Thank you.

11 JUDGE HOSEY: You have 15 minutes. Thank you.

12

13 PRESENTATION

14 MR. COOK: There is no dispute that Appellant  
15 filed each tax return for tax years 2014 through 2018  
16 late. And what's not at issue in this case is whether or  
17 not Appellant made a good-faith effort to come into  
18 compliance after it realized it was supposed to file  
19 California tax returns for those years. The only issue in  
20 this case is whether reasonable cause exist to abate the  
21 penalties that were assessed because those returns were  
22 filed late.

23 The well-established legal standard for finding  
24 that reasonable cause exists requires Appellant to provide  
25 evidence showing that an ordinarily intelligent and

1 prudent business person would have acted similarly under  
2 the same circumstances. It is also a well-established  
3 precedent that it is not reasonable cause when a taxpayer  
4 did not know it had a filing requirement. In this case,  
5 Appellant is arguing that it just decided not to file a  
6 return, and there's no, you know, reasonable cause basis  
7 for that either.

8 Supporting cases for the established precedence  
9 are not only found in FTB's opening brief, it can also be  
10 found in Board of Equalization decisions in Appeal of Jane  
11 Morris and Leila G. Forbes and Appeal of Diebold  
12 Incorporated. So Appellant's claim for reasonable cause  
13 is not supported by well-established law. You know, in  
14 the briefing Appellant argued that it wasn't even aware it  
15 had to file returns for these years. And so it's a new  
16 argument in this presentation that they did know, but they  
17 just decided not to.

18 If there is, you know, reasonable cause to be  
19 shown in this case, it would probably be in the realm of  
20 professional advice. And we don't have any evidence so  
21 far of any advice given to Appellants or any documentation  
22 of their decision making for the years at issue when the  
23 returns were supposed to be filed. Since there is no  
24 evidence that ordinary care and prudence was exercised  
25 concerning the tax returns for any years in this case, FTB

1 asks the OTA to sustain the penalties assessed for  
2 Appellant filing its returns rate.

3 Thank you, and I'm happy to answer any questions.

4 JUDGE HOSEY: Thank you, Mr. Cook.

5 Let me turn to my Panel and see if we have any  
6 questions for you.

7 Judge Katagihara?

8 JUDGE KATAGIHARA: This is Judge Katagihara.

9 Still no questions. Thank you.

10 JUDGE HOSEY: Judge Gast?

11 JUDGE GAST: This is Judge Gast. No questions.

12 Thanks.

13 JUDGE HOSEY: This is Judge Hosey again. I don't  
14 have any questions for you at this time either. So I'm  
15 going to go ahead and move forward.

16 Mr. Najjar, you have five minutes to respond to  
17 the Franchise Tax Board or to make any final comments  
18 before we end for today. You may begin when you're ready.

19 MR. NAJJAR: Sure, Judge Hosey.

20

21 CLOSING STATEMENT

22 MR. NAJJAR: Just to clarify, the taxpayer --  
23 when we say the taxpayer wasn't aware of their filing  
24 requirement, they weren't aware of the filing retirement  
25 given that -- with the physical presence rule. So they

1 didn't -- if there wasn't a physical presence in  
2 California in those years, they weren't aware that there  
3 would be something to file because it's not showing up in  
4 their data, per se.

5           And also in the realm of professional advice, I  
6 would wholeheartedly agree with the FTB that that is  
7 generally the case if we're looking at something that's  
8 nuanced in California statutes or regs that are very  
9 specific to this case -- you know, a case. But when  
10 something is widespread and so practiced for 30 years,  
11 well, more closer to five decades if you go back to  
12 National Bellas Hess, this is just industry-wide practice.  
13 It's been known. Every single tax adviser that Appellant  
14 could have approached would have provided the same answer.  
15 So I think, you know, an exception to having documented  
16 professional advice in like a tax technical memorandum  
17 would be if something is just so widespread and so widely  
18 known in a specific area of law that -- and, you know,  
19 Quill, Wayfair that's what it effects.

20           Also, establishing again what is well established  
21 law on reasonable cause in California, it doesn't -- it  
22 does address, again, that ignorance of the law is not  
23 enough, but there is that exception that if the position  
24 is taken as reasonable. We understand -- or the Appellant  
25 understands that that position with Quill turned out to be

1 wrong years later. And there was risk out there but it's  
2 not -- the question isn't if the position was right, it's  
3 if it was reasonable. So if someone working with  
4 Appellant would have said, yeah, this is a reasonable  
5 position to take.

6 Thank you. That's all I have.

7 JUDGE HOSEY: Thank you, Mr. Najjar.

8 This is Judge Hosey again. I'm going to see if  
9 we have any final questions from the Panel.

10 Judge Katagihara, any further questions for the  
11 participants today?

12 JUDGE KATAGIHARA: This is Judge Katagihara. No  
13 questions. Thank you.

14 JUDGE HOSEY: Judge Gast, any questions?

15 JUDGE GAST: This is Judge Gast. No further  
16 questions. Thank you.

17 JUDGE HOSEY: Thank you.

18 This is Judge Hosey again. I think we're ready  
19 to conclude the hearing. Evidence has been admitted into  
20 the record, and we have the arguments from your briefs as  
21 well as your oral argument presented today. We now have a  
22 complete record from which to base our opinion.

23 I wish again to thank both parties for their  
24 efforts in this matter. This concludes the hearing for  
25 this appeal. The parties should expect our written

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opinion no later than 100 days from today.

With that we are now off the record.

(Proceedings adjourned at 11:36 a.m.)

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HEARING REPORTER'S CERTIFICATE

I, Ernalyne M. Alonzo, Hearing Reporter in and for the State of California, do hereby certify:

That the foregoing transcript of proceedings was taken before me at the time and place set forth, that the testimony and proceedings were reported stenographically by me and later transcribed by computer-aided transcription under my direction and supervision, that the foregoing is a true record of the testimony and proceedings taken at that time.

I further certify that I am in no way interested in the outcome of said action.

I have hereunto subscribed my name this 25th day of July, 2023.

\_\_\_\_\_  
ERNALYN M. ALONZO  
HEARING REPORTER